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Bank D&O Liability: FDIC Litigation Update

Leveraging Developments in Standards of Liability, Statute of Limitations and Adverse Domination, Discovery, Insurance Coverage, and ESI

THURSDAY, OCTOBER 9, 2014

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Mary C. Gill, Partner, **Alston & Bird**, Atlanta

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FDIC LITIGATION UPDATE BANK OFFICERS & DIRECTORS

A Point/Counterpoint Discussion

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FDIC LITIGATION: BY THE NUMBERS

- **502** – Banks closed since 2008
- **145** – Lawsuits authorized by the FDIC against D&Os
- **97** – FDIC lawsuits filed against D&Os
- **1,171** –D&Os against whom the FDIC has been authorized to file suit
- **749** – D&Os against whom the FDIC has filed suit

FDIC LITIGATION: BY STATE

- 24 – Georgia
- 14 – California
- 12 – Florida
- 11 – Illinois
- 5 – Washington
- 4 – Nevada
- 3 – North Carolina, Puerto Rico, South Carolina
- 2 – Arizona, New Mexico
- 1 – Colorado, Indiana, Iowa, Kansas, Maryland, Michigan, Missouri, Nebraska, Oregon, Pennsylvania, Utah, West Virginia, Wisconsin, Wyoming

FDIC LITIGATION: BY YEAR

Year	Authorized D&O Defendants	Suits Filed
2009	**11**	0
2010	**98**	2
2011	**264**	16
2012	**369**	26
2013	**316**	40
2014	**113**	13

FDIC LITIGATION: SETTLEMENTS AND JUDGMENTS

- ~300 – Settlements published by FDIC
- 26 – Post litigation settlements
- 2 – Decisions on motions for summary judgment
- 1 – Trials

STANDARD OF LIABILITY: **DETERMINED UNDER STATE LAW**

- The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”) establishes **gross negligence** as a floor for officer and director liability.
- Under FIRREA, the FDIC may pursue claims against D&Os under a stricter standard of liability (*i.e.*, **ordinary negligence**), if permissible under state law.

STANDARD OF LIABILITY: GEORGIA

***FDIC v. Loudermilk*, 761 S.E.2d 332 (Ga. 2014)**

- **Certified Question:** "Does the business judgment rule in Georgia preclude as a matter of law a claim for ordinary negligence against the officers and directors of a bank in a lawsuit brought by the FDIC as receiver for the bank?"

FDIC v. Loudermilk

- "[T]he business judgment rule is a settled part of our common law in Georgia, and it generally precludes claims against officers and directors for their business decisions that sound in ordinary negligence, except to the extent that those decisions are shown to have been made without deliberation, without the requisite diligence to ascertain and assess the facts and circumstances upon which the decisions are based, or in bad faith."

- "[T]he **wisdom of the decision** is ordinarily insulated from judicial review, and as for the **process by which the decision was made**, the officers and directors are presumed to have acted in good faith and to have exercised ordinary care. Although this presumption may be rebutted, the plaintiff bears the burden of putting forward proof sufficient to rebut it."

FDIC v. Loudermilk

- "[B]ank officers and directors are only expected to exercise the same diligence and care as would be exercised by 'ordinarily prudent' officers and directors of a similarly situated bank."
- The Georgia statute, "conclusively presumes that it is reasonable for an officer or director to rely upon certain information as a part of the diligence with which the standard of ordinary care is concerned."

STANDARD OF LIABILITY: GEORGIA

***FDIC v. Skow*, 2014 WL 4670371 (Ga. Sept. 22, 2014)**

- **Certified Question:** "Does a bank director or officer violate the standard of care established by O.C.G.A. § 7-1-490 when he acts in good faith but fails to act with 'ordinary diligence,' as that term is defined in O.C.G.A. § 51-1-2?"
- **Certified Question:** "In a case like this one, applying Georgia's business judgment rule, can the bank officer or director defendants be held individually liable if they, in fact as alleged, are shown to have been ordinarily negligent or to have breached a fiduciary duty, based on ordinary negligence in performing professional duties?"

FDIC v. Skow

- "A bank director or officer may violate the standard of care . . . even where he acts in good faith, where, with respect to the process by which he makes decisions, he fails to exercise the diligence, care, and skill of 'ordinarily prudent men [acting] under similar circumstances in like positions. . . .'"
- "[P]rocess in this context refers to the mode by which one deliberates and ascertains the facts relevant to the decision at hand. . . . the level of diligence required is only that as would be exercised by 'ordinarily prudent' officers and directors of a similarly situated bank."

FDIC v. Skow

- "In a case like this one, the bank officer or director defendants may be held individually liable if they are shown to have violated the standard of care established by O.C.G.A. § 7-1-490, as construed in *Loudermilk*."

Georgia Post-*Loudermilk*

FDIC v. Boggus, No. 2:13-cv-00162-WCO (N.D. Ga. Aug. 25, 2014)

- "Plaintiff adequately alleges procedural defects in the loan approval process. Although defendants may later find statutory sanctuary from liability, the exact contours of whether defendants exercised sufficient diligence to 'ascertain the relevant facts' may not be decided on the pleadings alone."

STANDARD OF LIABILITY: NORTH CAROLINA

***FDIC v. Willetts*, No. 7:11-cv-165-BO (E.D.N.C. Sept. 11, 2014), Dkt. No. 42**

- "The business judgment rule involves two presumptions. First, it establishes 'an initial evidentiary presumption that in making a decision the directors [and officers] acted with due care (i.e., on an informed basis) and in good faith in the honest belief that their action was in the best interest of the corporation.' Second, the business judgment rule establishes, absent rebuttal of the first presumption, a 'powerful substantive presumption that a decision by a loyal and informed board will not be overturned by a court unless it cannot be attributed to any rational business purpose.'"
- "[T]he business judgment rule precludes the court from delving into whether or not the decisions were 'good,' limiting the court to a determination of whether the decisions were made in 'good faith' or were founded on a 'rational business purpose.'"

FDIC v. Willetts

- "Although there were clearly risks involved in Cooperative's approach, the mere existence of risks cannot be said, in hindsight, to constitute irrationality. Further, corporations are expected to take risks and their directors and officers are entitled to protection from the business judgment rule when those risks turn out poorly."
- "Where, as here, defendants do not display a conscious indifference to risks and where there is no evidence to suggest that they did not have an honest belief that their decisions were made in the company's best interests, then the business judgment rule applies even if those judgments ultimately turned out to be poor."

FDIC v. Willetts

- "It appears that the only factor between defendants being sued for millions of dollars and receiving millions of dollars in assistance from the government is that Cooperative was not considered to be 'too big to fail.' Taking the position that a big bank's directors and officers should be forgiven for failure due to its size and an unpredictable economic catastrophe while aggressively pursuing monetary compensation from a small bank's directors and officers is unfortunate if not outright unjust."

FDIC v. Willetts

- "Under North Carolina law, gross negligence has the same basic elements as negligence, but ***requires either intentional wrongdoing or deliberate misconduct*** affecting the safety of others, such as when the act is done purposely and with knowledge that such act is a breach of duty to others." ***Boykin Anchor Co., Inc. v. AT&T Corp.,* 825 F. Supp. 2d 706 (E.D.N.C. 2011) (emphasis added)**.

Post *Willetts*

- FDIC filed a Notice of Appeal on October 2, 2014.
- Intersection with 12 U.S.C. § 1821(k)?
- "In light of *Atherton*, we have serious doubts about whether it is permissible to borrow from state law a definition of 'gross negligence' that effectively raises the standard of culpability to recklessness." ***FDIC-R Broadway Bank v. Giannoulias,*** **No. 1:12-cv-01665 (E.D. Ill. Jan. 16, 2013).**

POTENTIAL DEFENSES TO CONSIDER

- Business Judgment Rule
- Reliance on management, committees, or advisors
- Failure to establish elements of liability
- Failure to mitigate damages
- Comparative or contributory fault
- Statute of limitations

AFFIRMATIVE DEFENSES

O'Melveny & Myers v. FDIC, 512 U.S. 79 (1994)

- In *O'Melveny & Myers v. FDIC*, the Supreme Court rejected the premise of "federal common law," upon which the FDIC had primarily relied in arguing that a "no duty" rule afforded it unique protections from affirmative state-law defenses.
- The Court held that neither federal policy nor FIRREA itself created a federal rule to protect the FDIC, concluding that "any defense good against the original party is good against the receiver."
- **Exception:** Where a "'previously established and long standing' rule of federal common law predated FIRREA's enactment." *FDIC v. Skow*, 741 F.3d 1342, 1347 (11th Cir. 2013).

AFFIRMATIVE DEFENSES

Post-O'Melveny & Myers v. FDIC

- ***FDIC v. Skow*, 741 F.3d 1342, 1349 (11th Cir. 2013)** (holding that the FDIC "failed to demonstrate the existence of an established and long-standing common law rule barring Defendants' affirmative defenses" so as to exempt the "no-duty" rule from preclusion under *O'Melveny & Myers*).
- ***W Holding Co., Inc. v. AIG Ins. Co.*, No. 3:11-cv-02271-GAG-BJM (D.P.R. Aug. 8, 2014), Dkt. No. 1166** (denying FDIC's motion for summary judgment on defendants' failure to mitigate affirmative defense).
- ***FDIC v. Willetts*, 882 F. Supp. 2d 859, 870 (E.D.N.C. 2012)** (denying FDIC's motion to strike affirmative defenses and holding "[t]hat after *O'Melveny*, 'state law controls what defenses are available against the FDIC when the agency is acting as the receiver of a failed financial institution.'").

AFFIRMATIVE DEFENSES

Post-O'Melveny & Myers v. FDIC

- ***FDIC v. Appleton*, No. 2:11-cv-00476-JAK-PLA (C.D. Cal. July 23, 2012)** (holding that "the no duty rule remains viable following the Supreme Court's decision in *O'Melveny & Myers v. FDIC*").
- ***FDIC v. Van Dellen*, No. 2:10-cv-04915-DSF-SH (C.D. Cal. Sept. 27, 2011)** (barring defendants from raising certain affirmative defenses to extent they were based on FDIC's post- or pre-receivership conduct, because the defenses could not have been asserted against the bank).

AFFIRMATIVE DEFENSES: STATUTE OF LIMITATIONS

- FIRREA Section 1821(d)(14)(A) - Statute of limitations or statute of repose?
  - ***FDIC v. Jones*, No. 2:13-cv-00168-JAD-GWF (D. Nev. Sept 19, 2014), Dkt. No. 79** (holding that section 1821(d)(14)(A) is a statute of limitations, that it could be tolled by agreement, and that state limitations period reset upon appointment of FDIC as receiver).
  - ***W Holding Co., Inc. v. Chartis Insur. Co.*, No. 3:11-cv-02271-GAG (D.P.R. Oct. 23, 2012)** (applying adverse domination doctrine to toll statute of limitations).
  - ***National Credit Union Administration Board v. Credit Suisse Securities USA LLC*, No. 12-2648-JWL, 2013 U.S. Dist. LEXIS 95749 (D. Kan. July 10, 2013)** (holding that extender statute may not be tolled by the agreement of the parties).

DISCOVERY DISPUTES

- Which party bears the costs of producing ESI?
- What documents are within the FDIC-R's possession, custody and control?
- Are regulatory documents protected from discovery?

The Failed Bank Crisis: Update On The Insurance Debate

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Introduction

- Multiple years in to this event, what coverage issues are being debated?
  - Insured v. Insured exclusion
  - “Loan Loss” exception
  - Regulatory exclusion
  - “Prior acts” exclusions/retroactive dates

Insured vs. Insured Exclusion

- Is underlying action “collusive”?
- Does the policy contain a “bankruptcy trustee” carve out?
- Is the FDIC truly acting as or on behalf of the “company”?
- Is the FDIC a “genuinely adverse party”?
- Is the FDIC acting as a creditor representing other creditors?
- Is the exclusion at least “ambiguous” with respect to application to FDIC?

Insured vs. Insured Exclusion

Cases Holding Exclusion Inapplicable

Insured vs. Insured Exclusion

Michigan Heritage Bank (E.D. MI 2012), insurer summary judgment motion denied:

“the FDIC has shown that some ambiguity exists in the insured vs. insured exemption [sic] due to the 'security holder exception,' the omission of a regulatory exclusion, and statements by plaintiff that regulatory suits, which might include the instant action are covered.”

Insured vs. Insured Exclusion

W. Holding Co. v. Chartis (D. Puerto Rico 2012):

Exclusion inapplicable because:

- When regulatory agency asserts claims on behalf of both insured organization and third-party interests, its applicability is ambiguous.
- Purpose of exclusion is to deter collusion.
- Policy defined “organization” as named entity, each subsidiary and debtors in BK proceedings; none of which were the FDIC.

Insured vs. Insured Exclusion

Progressive v FDIC (N.D. Ga. 2013):

Exclusion inapplicable because:

•it is unclear whether the FDIC as receiver's claims are "by" or "on behalf of" the failed bank.

•court cited multiple roles FDIC takes on in representing the insured, depositors, creditors, and shareholders to support conclusion that exclusion is ambiguous.

Insured vs. Insured Exclusion

W. Holding Co. v. AIG (1st Cir. July 9, 2014):

•Court held that there was a duty to advance defense costs despite IvI exclusion.

•Insurer argued that the FDIC was proceeding only its capacity as receiver. However, FDIC alleged not only that it had succeeded to the rights of the failed bank, but also that it had succeeded to the rights of the bank's depositors and account holders, and also that it was suing to recover "money the insurance fund had shelled out" after the bank failed.

Insured vs. Insured Exclusion

St. Paul Mercury Ins. Co. v. Hahn (C.D. Cal tent. Oct. 6, 2014)

•Exclusion inapplicable, as FDIC represents a number of interests, and does not simply act on behalf of the failed bank.

•"Repeated disputes over the IvI Exclusion have placed insurers on notice that it is ambiguous" and "any ambiguity . . . is to be resolved against the insurer."

• "Travelers had the opportunity to make clear in the Policy that the IvI exclusion applied to FDIC-R, and it could have done so with a simple statement."

Insured vs. Insured Exclusion

Cases Holding Exclusion Applicable

Insured vs. Insured Exclusion

Hawker v. Bancinsurance (E.D. Cal. Apr. 7, 2014):

- Exclusion applicable where it expressly referred to "a claim by . . . any other insured person, the company, or any successor, trustee, assignee or receiver of the company."
- While "not accusing the FDIC of collusion," Court noted that the interests of the FDIC as receiver "could be aligned with the interests of the directors and officers of a failed bank when an insurer is involved."
- Unusual express reference to a company's "receivers" key. Judge distinguished cases finding coverage on this basis.

Insured vs. Insured Exclusion

St. Paul v. Miller (N.D. Ga. 2013) (Currently on appeal—Oral Argument 10/14/14):

Exclusion applicable:

•Court relied upon O'Melveny & Myers, 512 U.S. 79 (1994) and concluded that the exclusion unambiguously applied because FDIC "step[ped] into the shoes" of the failed bank.

•Court rejected all arguments relied upon by other courts in finding the exclusion inapplicable (i.e. absence of collusion, public policy)

Insured vs. Insured Exclusion

St. Paul v. Miller (N.D. Ga. 2013):

However:

- Court expressly limited decision to policy language before it (precluding coverage for loss "on account of any Claim made against any Insured . . . Brought or maintained by or on behalf of any Insured or Company in any Capacity.")

Insured vs. Insured Exclusion

St. Paul v. Miller (N.D. Ga. 2013):

Arguments on Appeal:

- The plain language of the IvI exclusion does not apply, because the FDIC is not a named insured, and brings suit for the benefit of the receivership and third parties, not the Bank.
- This interpretation does not read the phrase of “on behalf of” out of the policy, as it could apply to others (i.e. holding co’s debtor-in-possession)
- Insurer could have expressly excluded FDIC claims from coverage.

Insured vs. Insured Exclusion

St. Paul v. Miller (N.D. Ga. 2013):

Arguments on Appeal:

- Purpose of IvI exclusion to preclude coverage for potentially collusive claims, as demonstrated by shareholder derivative action exception.
- At a minimum, IvI exclusion ambiguous.

“Loan Loss” Exception

Loss Definition sometimes excludes: “any unrepaid, unrecoverable or outstanding loan, lease or extension of credit to any … Borrower.”

Insurers now looking at this exception as additional basis to deny coverage.

“Loan Loss” Exception

Progressive v FDIC (N.D. Ga. 2013):

Exclusion inapplicable because “ambiguity exists in the definition of ‘loss’” and the “loan loss carve-out” does not “clearly exempt tortious claims” brought by the FDIC in the underlying D&O liability action.

“Regulatory” Exclusion

Hawker v. Bancinsurance (E.D. Cal. 2014):

- “The regulator exclusion would bar suits brought by the FDIC in its capacity as federal insurer, also known as its ‘corporate capacity,’ whereas the insured v. insured exclusion would only bar claims by the FDIC in its capacity as receiver.”
- Insured v. insured exclusion in that case expressly included suits by a “receiver.”

“Regulatory” Exclusion

Reis v. FDIC (C.D. Cal. 2013):

- Coverage barred where unusually broad regulatory exclusion provided that “the Company shall not be liable for Loss on account of any Claim by, on behalf of, or at the behest of . . . the Federal Deposit Insurance Corporation . . . in any capacity whatsoever.”

Conclusion

Biography

Linda D. Kornfeld is a partner in the Kasowitz's Litigation Department and a member of the Insurance Litigation and Counseling Practice. A nationally recognized insurance coverage litigator whom *Chambers USA* has described as one of "the best attorneys in California" for coverage litigation, Ms. Kornfeld has extensive trial and appellate experience representing corporate and individual policyholders in high-stakes litigation in California and across the country.

Ms. Kornfeld has assisted clients in obtaining substantial recoveries in various types of insurance matters. Linda presently is representing clients in Directors and Officers coverage litigation related to failed banks.

Ms. Kornfeld has been repeatedly cited as an exceptional insurance litigator and one of the top women lawyers in California by leading legal publications and directories, including *Chambers USA*, since 2007; and in 2011 she was included as one of Lawdragon's top 500 "leading lawyers" in America, and named by *Benchmark Litigation* as a "Litigation Star" both nationally and in California.

Ms. Kornfeld also has been recognized by the *Daily Journal* as one of California's top 100 women litigators, by *Business Insurance* as one of the country's "50 Women to Watch" in insurance, in *Southern California Super Lawyers*, as one of the top 50 women lawyers in Southern California. Ms. Kornfeld also is included in the Legal Media Group's *Guide to the World's Leading Insurance and Reinsurance Lawyers*.

Biography

Kirsten C. Jackson works on behalf of companies to recover insurance assets. She assists in obtaining millions of dollars in insurance coverage for clients under commercial general liability, professional liability, directors and officers liability, errors and omissions liability, and life insurance. Kirsten is experienced in all stages of litigation and non-adversarial dealings with insurers, including coverage analysis and advising, claims correspondence, mediations, pleadings, written discovery, document production, depositions, motion practice, trial preparation and settlement. Kirsten was recognized in “Who’s Who Legal” and Lawyers of Color’s “Hot List.”